

PRICING AMERICAN OPTIONS USING FOURIER ANALYSIS

A Thesis Submitted for the Degree of
Doctor of Philosophy

by

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in

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January 5, 2005

Certificate

I certify that the work in this thesis has not previously been submitted for a degree nor has it been submitted as part of requirements for a degree except as fully acknowledged within the text.

I also certify that the thesis has been written by me. Any help that I have received in my research work and the preparation of the thesis itself has been acknowledged. In addition, I certify that all information sources and literature used are indicated in the thesis.

Signed *A. Zogas*

Date *19-1-2005*

Acknowledgements

First and foremost, I am extremely grateful to my supervisor Carl Chiarella. This thesis would not have been possible without his excellent supervision and never-ending support. His experience, encouragement and advice have been invaluable throughout the entire research process. Thanks also to my co-supervisor Tony Xue-Zhong He for his suggestions and assistance.

During the course of my research, discussion with numerous people provided extremely valuable insight that helped me in completing the thesis. I wish to thank Giovanni Barone-Adesi, Peter Buchen, Jeff Dewynne, Nadima El-Hassan, Adam Kucera, John van der Hoek and Nick Webber for their ideas and suggestions concerning the topic under investigation.

Thanks to the School of Finance and Economics at UTS for providing me with a friendly, comfortable environment in which to work, and also for their support towards attending several international conferences. In addition, many thanks to Jingfeng He and Jenny Yixin Chen for all their help with type-setting many of the mathematical proofs and diagrams.

Finally I thank my parents, Tim and June, and my sister Melissa, for their ongoing understanding and support.

Contents

Abstract	vi
Chapter 1. Introduction	1
1.1. Literature Review and Motivation	1
1.2. Structure of the Thesis	8
Chapter 2. Pricing American Options under Geometric Brownian Motion	13
2.1. Introduction	13
2.2. Problem Statement - Monotonic Payoff	15
2.3. Applying the Fourier Transform	17
2.4. Inverting the Fourier Transform	20
2.5. Alternative Representations of the American Call Value	23
2.6. American Call as a Compound Option	27
2.7. Numerical Examples	30
2.8. Conclusion	35
Appendix 2.1. Fundamental Results	36
Appendix 2.2. The Incomplete Fourier Transform	37
Appendix 2.3. Properties of the Incomplete Fourier Transform	38
Appendix 2.4. Derivation of the American Call Integral Expression	39
Appendix 2.5. Alternative Representations of the American Call Price	42
Appendix 2.6. Value of the American Call Free Boundary at Expiry	49
Appendix 2.7. Induction Proof for the American Call Option Price	51
Chapter 3. Evaluation of American Option Portfolios	61
3.1. Introduction	61
3.2. Problem Statement - American Strangle	63
3.3. Applying the Fourier Transform	65
3.4. Inverting the Fourier Transform	68

3.5. The Kim-Type Representation	70
3.6. Numerical Implementation	72
3.7. Results	75
3.8. Conclusion	85
Appendix 3.1. The Two-Sided Incomplete Fourier Transform	87
Appendix 3.2. Properties of the Two-Sided Incomplete Fourier Transform	87
Appendix 3.3. Derivation of the American Strangle Integral Equations	89
Appendix 3.4. Derivation for the Perpetual American Strangle	91
Appendix 3.5. Value of the American Strangle Free Boundaries at Expiry	94
Appendix 3.6. Algorithm for Evaluating the American Strangle	98
 Chapter 4. Pricing American Options under Jump-Diffusion	 100
4.1. Introduction	100
4.2. Problem Statement - Merton's Model	103
4.3. Applying the Fourier Transform	106
4.4. Inverting the Fourier Transform	108
4.5. American Call with Log-Normal Jumps	116
4.6. Numerical Implementation and Results	124
4.7. Conclusion	129
Appendix 4.1. Properties of the Incomplete Fourier Transform	131
Appendix 4.2. Derivation of the American Call Integral Equations	132
Appendix 4.3. Deriving Proposition 4.4.5	147
Appendix 4.4. American Call Evaluation for Log-Normal Jumps	154
Appendix 4.5. Simplifying the Cost Term	158
Appendix 4.6. Deriving the Perpetual American Call under Jump-Diffusion	160
Appendix 4.7. Value of the Free Boundary at Expiry	163
Appendix 4.8. Algorithm for Evaluating the American Call Option under Jump-Diffusion	 173
 Chapter 5. Fourier-Hermite Series Expansion for American Calls under Jump- Diffusion	 174
5.1. Introduction	174
5.2. Problem Statement - Log-Normal Jumps	176

CONTENTS

v

5.3. Evaluation of European Call Options	177
5.4. Evaluation of American Call Options	181
5.5. Numerical Implementation - American Call	184
5.6. Results	186
5.7. Conclusion	193
Appendix 5.1. Hermite Coefficients for the European Call	194
Appendix 5.2. Hermite Coefficients for the American Call	203
Appendix 5.3. Fourier-Hermite Algorithm for the American Call Option under Jump-Diffusion	210
Chapter 6. Conclusion	212
6.1. Summary of Findings	212
6.2. Directions for Future Research	217
Bibliography	220

Abstract

The analytic expression for an American option price under the Black-Scholes model requires the early exercise boundary as one of its inputs, and this is not known a priori. An implicit integral equation can be found for this free boundary, but it has no known closed-form solution, and its numerical solution is highly non-trivial. This has given rise to a number of analytical solution methods and numerical techniques designed to handle the early exercise feature.

The aim of this thesis is to explore Fourier-type solution methods for pricing American options. The price is defined as a free boundary value problem, whose solution satisfies the Black-Scholes PDE with certain final and boundary conditions. This problem is solved using the incomplete Fourier transform method of McKean (1965). The method is generalised to American options with monotonic and convex payoffs in a systematic way, and is further extended by applying it to solve the PIDE for the American call option under Merton's (1976) jump-diffusion model. In this case numerical integration solutions require an intense level of computation. The thesis considers the Fourier-Hermite series expansion method as an alternative approach. This is extended to allow for jump-diffusion with log-normally distributed jump sizes. The main contributions of the thesis are:

- *Evaluation of American Options under Geometric Brownian Motion - Chapters 2 and 3.* The details of McKean's (1965) incomplete Fourier transform are provided for a monotonic payoff function, and several forms for the price and free boundary are reproduced in the case of an American call. A numerical scheme for implementing the equations is given, along with a comparison of several existing numerical solution methods. The applicability of the transform technique to more general payoff types is demonstrated using an American strangle position with interdependent component options. A coupled integral equation system for the two free boundaries is found and solved using numerical integration. The resulting free boundaries are consistently deeper in-the-money than those for the corresponding independent American call and put.
- *Pricing American Options under Jump-Diffusion - Chapter 4.* The incomplete Fourier transform method is applied to the jump-diffusion model of Merton (1976). The PIDE for an American call is solved, and the results are simplified to replicate the integral equations of Gukhal (2001) for the price and free

boundary. An implicit expression for the limit of the free boundary at expiry is derived, and an iterative algorithm is presented for solving the integral expressions numerically. The results are demonstrated to be consistent with existing knowledge of American options under jump-diffusion, and display behaviour that is consistent with market-observed volatility smiles.

- *Fourier-Hermite Series Expansions for Options under Jump-Diffusion - Chapter 5.* The Fourier-Hermite series expansion method is extended to the jump-diffusion model of Merton (1976) in the case where the jump sizes are log-normally distributed. With the aid of a suitably calibrated scaling parameter, the method is used to evaluate American call options. The pricing accuracy of this approach is shown to be comparable to both the iterative numerical integration method, and the method of lines technique by Meyer (1998). The series expansion method displays a high computation speed in exchange for some loss of accuracy in the free boundary approximation.